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DISCOVER FINANCIAL SERVICES NSA	**MC2015-3**
DISCOVER FINANCIAL SERVICES NSA	**R2015-2**

Comments of Discover Financial Services

(November 17, 2014)

Discover Financial Services (Discover) hereby submits these Comments concerning the Negotiated Service Agreement (NSA) that the Commission has before it in these dockets. This is the third NSA that the Postal Service and Discover have agreed to over the last 10 years.

Preliminary

This NSA is different. There are several elements that distinguish it from others that have previously come before the Commission. First, this NSA is not a declining block rate deal, where discounts are provided only on pieces above thresholds. Rather, by necessity, the dynamic is a more fundamental one, that of increasing the value of the overall postal product, so that this product can more effectively compete against eight other targeted marketing channels—and do so in a way that incents further growth. Second, while this NSA bears some structural resemblance to Discover's previous NSA, the context of this NSA is much different, as is its importance to the future of the Postal Service. This NSA is a competitive effort by the Postal Service to avoid losing Standard

Mail revenue to one of the largest set of competitors that the Postal Service faces today: the digital marketing channels.

In considering this NSA, it may be helpful to keep in mind that the *only* statutory issue at play in this case is whether this NSA improves the net financial position of the Postal Service.[1] If the Commission finds that this NSA does improve the financial position of the Postal Service, then it must approve the NSA. The Commission has discretion about how to judge the NSA before it. There is no statutory requirement for a minimum improvement, nor any requirement for any sort of quantitative finding.

Nor is there any legal issue with the Commission using a different approach—quantitative or nonquantitative—than it has in the past to evaluate NSAs. All the Commission need do is adequately explain that what it is doing is a change from past practices. The seminal case in this area is Greater Boston Television Corp. v. FCC, 444 F.2d 841, 852 (D.C. Cir.), cert denied, 403 U.S. 923 (1971)(An agency changing its course must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored. . . ."). See also ExxonMobil Oil Corp. v. FERC, 487 F.3d 945 (D.C.Cir 2007)(agency permissibly clarified prior policy by addressing issue that was not previously on its radar screen); National Assn'n of Clean Air Agencies v. EPA, 489 F. 3d 1221 (D.C. Cir. 2007)(agency adequately explained why case was unique); Center for Native Ecosystems v. Cables, 509 F.3d 1310 (10th Cir. 2007)(agency properly applied its expertise as basis to change policy); British Steel v. United States, 127 F.3d 1471 (Fed Cir 1997)(agency can change its traditional methodology); C.K. v. New Jersey Department of Health & Human Services, 92 F.3d

[1] The issue of enhancing the performance of mail preparation, processing, transportation, or other functions is a not an issue in this NSA. Nor is there any basis in the structure or output of this NSA to suggest that it would unreasonably harm the marketplace. See 39 U.S.C. §3622(c)(10)(A) and (B).

171 (3dCir. 1996)(Secretary can change her mind in light of experience); Cavert Acquisition Co. v. NLRB, 83 F.3d 598 (3d Cir. 1996)(agency can clarify its policy on an issue when it discovers inconsistencies in its precedents). Finally, as the Supreme Court recently pointed out, in changing its course, an agency has no heightened duty to provide reasons that are more substantial than those required to adopt a policy in the first instance. FCC v. Fox Television Stations, 556 U.S. 502 (2009).

I
Discover Is On the Cutting Edge of Digital Marketing; This is Changing Its Use of Mail and Its Relationship with the Postal Service

Discover is not a conventional bank. Rather, it is a direct bank:[2]

> A direct bank is a bank without any branch network that offers its services remotely via online banking and telephone banking and may also provides access via ATMs (often through interbank network alliances), mail and mobile. . . . The concept of a direct bank gained prominence with the advent of online banking technology in the early 1990s which led to a number of direct banks being created, although many were owned by traditional banks

http://en.wikipedia.org/wiki/Direct_bank

By necessity, direct banks have to be on the cutting edge of digital technology, digital banking, and digital marketing because they have no brick-and-mortar branches. Discover has been using digital marketing channels since their inception. As the Statement of Discover's Chief Marketing Officer Harit Talwar in these dockets shows, while the results from those channels showed great potential year after year, for many years their actual results were usually somewhat "less than robust."

[2] STATEMENT OF HARIT TALWAR, DISCOVER FINANCIAL SERVICE EXECUTIVE VICE PRESIDENT, PRESIDENT—U.S. CARDS, AND CHIEF MARKETING OFFICER, Submitted to the Postal Regulatory Commission in Dockets MC2015-3, R2015-2 on October 28, 2014 at pg. 4.

That has changed. Those digital marketing channels, as the Talwar Statement details, are no longer young, immature promotional media, but have grown into robust, highly adaptive, and ever more effective marketing channels that now, in fact, compete head-to-head with mail. As CMO Talwar said:

> While our digital marketing channels once were rather immature marketing outlets, albeit with an enormous potential, that is no longer true today. Rather, our digital channels are now viable, effective, cost-efficient channels with higher adoption rates that reach far more recipients at a much lower price than mail. Moreover, they are producing an increasingly higher quality of digitally acquired customers.[3]

This maturing of the digital outlets into effective marketing channels has had a number of significant consequences on the relationships between Discover, its marketing program, and the Postal Service. These consequences are responsible for a significant structural change, a paradigm shift if you will:

1. Standard Mail is no longer a monopoly product for Discover since it now operates in a highly competitive market that includes a wide variety of targeted digital channels.[4]

2 The budget allocation of mail and digital in Discover's target marketing budget has changed dramatically. Mail has lost ground to the digital channels even though Discover's mail spend has grown dramatically in past years, in no small thanks to our previous NSA.[5]

3 The results from digital marketing channels have now surpassed mail, and digital channels are now Discover's prime means of acquisition.[6]

4 But for this NSA, Discover would be moving more marketing dollars out of the mail channel and into the digital channels, each year.[7] The cumulative effects of

[3] Talwar at 4
[4] Talwar at 3.
[5] Talwar at 4.
[6] Talwar at 4.

that shift would be significant for both parties, with the impact on the Postal Service decidedly negative.

5 The relationship of Discover and the Postal Service is going through a subtle but important evolution. Discover senior executives now respect and treat the Postal Service just as they do any other vendor, rather than with the outsized deference engendered by a monopoly provider from which they must buy services.[8] This is a significant change and it is one to which the Postal Service must adjust in order to remain competitive.

Given these changes, not surprisingly, Discover's marketing is also undergoing a significant structural change as these Comments and CMO Talwar's Statement make clear. In fact, it is at a turning point. In light of this, Discover commends the Postal Service and its Chief Marketing Officer and Vice President of Sales for their attitude and approach in negotiating this NSA. The Postal Service executives listened attentively to the customer, asking exactly what the Postal Service needed to do in order to keep its business, and then negotiated in a fair but tough way with that acquired knowledge. Among other things, the Postal Service sought to get ahead of the curve and to influence behavior *before* losing significant business. This is a best practice of any business. Not only is this *precisely* what a good vendor does with its customers, but it is *exactly* what Congress wanted the Postal Service to do with the pricing flexibility it gave the Postal Service in the PAEA, as is discussed below.

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[7] Talwar at 4-5.

[8] Relationships between monopolies and their customers are interesting constructs, and much different than relationships between companies in a competitive environment and their vendors. Conflicting peculiarities permeate relationships between monopolies and their customers, as is normal in a relationship where one side is dependent upon the services of the other, and has no viable alternatives. When the monopoly disappears and the customer is no longer dependent upon the services of the other party, relationships have to change or significant levels of business will be lost to other firms. *Cf.* 39 U.S.C.§ 3642(b)(1) (using the risk of losing significant levels of business as a test for the lack of market power).

There is much at stake here for the Postal Service. The Postal Service has an enormous incentive to see that Discover does not start decreasing its Standard Mail marketing spend in order to fund its digital channel marketing efforts.[9] As CMO Talwar noted in his Statement, the unprecedented success of Discover's digital marketing efforts and the efficiency of its digital marketing channels would make shifting marketing dollars a normal order of business for Discover, but for this NSA.[10] Although Discover did not anticipate this turn of events when the last NSA was negotiated, as it turned out, that NSA prevented a shift of marketing dollars out of mail, and this NSA needs to continue that. The consequences of Discover shifting marketing dollars out of mail and into digital could be severe for the Postal Service.

First, the sum at play is significant. If Discover moved only $20 million out of mail and into digital each year for three years, the cumulative loss for the Postal Service from Discover's shift would be $120 million over three years. If Discover were a bit more aggressive, and moved $30 million each year, the three-year cumulative loss would be $180 million. If Discover were yet even more aggressive, and moved $40 million each year, the three-year cumulative loss would be $240 million. Those are large sums of money.

Second, given the paradigm shift that is occurring, marketing dollars that leave mail for digital channels are not likely to return.[11]

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[9] Trends like this, once started, tend to gain a momentum all their own, and can be extremely difficult to stop. This is because the effort it takes to reverse such a trend, once started, is much greater than the effort it would have taken to initially avoid such a trend.
[10] Talwar at 4 and 6.
[11] Talwar at 6. As footnote 9 discusses, it is very difficult to reverse an evolutionary market trend, once it has started.

Third, Discover is a innovator in the industry. If Discover suddenly would shift, that shift would be noticed by everyone. If other financial services institutions decided to follow Discover's lead, this could be a game changer for the Postal Service, and not in a positive fashion.

II
This NSA Is Exactly the Type of Response to the Digital Age that the Postal Accountability and Enhancement Act Intended to Encourage

The significance of this NSA goes far beyond the value of the deal to Discover and the Postal Service. This is the first attempt by the Postal Service, in the form of an NSA, to respond *directly* to changing conditions in the marketing industry—specifically the growing effectiveness of digital marketing choices. This NSA offers a customer an incentive to maintain their total mail spend, based on feedback from the customer as to what the Postal Service must do in order to maintain its business. This is the type of Postal Service response that the PAEA not only intended to allow, but indeed intended to *encourage,* as is discussed in the next several pages.

Put another way, this NSA represents an important building block in the Postal Service's strategy to generally work with customers to preserve hundreds of millions of dollars of postal revenue, in the face of the long-anticipated arrival of digital marketing as effective competitors to marketing mail. This NSA not only accomplishes this task, but it does so by requiring modest growth. Thus Discover respectfully submits, the Commission should not only approve this NSA, it should do so in a manner that compliments the Postal Service for walking the walk on innovation and competition, rather than just talking the talk. Should the Commission act in such a fashion, it would be acting in harmony with Congress' expressed desire to encourage the Postal Service to innovate and better compete in the digital marketplace.

In December of 2006, the Postal Accountability and Enhancement Act became law. That law was the response from Congress to the fact that the postal needs of America in the 21st Century were much different from the postal needs of America in 1970, when the Postal Reorganization Act became law. As Senator Tom Carper (D DE), the major Democratic champion of the PAEA pointed out:

> The world has changed dramatically, and also the way that we exchange information, the way we communicate with one another has changed dramatically, too. The Postal Service needs to change as well. With the adoption of this legislation, it will.[12]

When the bill came to the floor of the Senate, Senator Carper specifically cited the changes in the digital communications landscape as the fundamental catalyst that had ignited Congress' drive to change the way the Postal Service and the PRC had done business since 1970:

> At the time [of the Postal Reorganization Act of 1970] and for many years thereafter, it [the Postal Reorganization Act] was the right business model for providing postal service to the people of this country. But a lot has changed since 1970. . . .we didn't have any e-mails. . . . We had no cell phones with which to communicate with our loved ones. We had no bank by phone. We had no electronic banking. Direct deposits were new.[13]

Senator Carper purposely pointed out that in the PAEA, Congress was changing the rules of the game, and that it was doing so in order to encourage the Postal Service to "act more like a business"[14] and specifically to "price their products more competitively."[15] Senator Carper was talking of market dominant products when he made these remarks, *not* competitive products, for he noted that these activities would

[12] 152 *Cong. Rec.* S11675. S11676 (2006)(Statement of Sen. Carper).
[13] Id. at 11675.
[14] Id. at 11676.
[15] Id. at 11676.

be limited by the rate cap.[16] Also, the Postal Service's competitive products tend to be delivery products, rather than communications products.

On the Republican side of the Senate, Senator Susan Collins, Chairman of the Homeland Security and Governmental Affairs Committee and a stalwart proponent of updating the Postal Service ability to compete and survive in a digital age, affirmed that Senate intent, noting that the "the 225 year-old Postal Service [must] meet the challenges of the 21st century,"[17] particularly "the challenge of the electronic age."[18] That is exactly what is going on in this NSA. The Postal Service is directly trying to meet the challenge of the digital age, and doing so on a very granular basis.

Not surprisingly, the House of Representatives reflected this same intent. As the relevant[19] House Report states:

> The objective of the bill is to position the Postal Service to operate in a more business-like manner. To achieve this goal, the system must be responsive to market considerations. . . . The bill gives postal management . . . tools to adapt and survive in the face of enormous challenges caused by changing technology and dynamic communications marketplace. The bill also allows the Postal Service to better react to market conditions by . . . permitting rates that are better tailored to [postal] consumers needs.[20]

In this NSA, the Postal Service is trying to meet the "enormous challenges caused by changing technology" in the "dynamic communications marketplace," cited by the House Report. Moreover, it is trying to do so in a very targeted and direct fashion that is tailored to one postal customer, just as the author of that Report cited above foresaw.

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[16] Id. at 11676.
[17] 152 *Cong. Rec.* S1174, (Statement of Sen. Collins)
[18] Id.
[19] As the Congressional Record remarks of both Congressmen John M. McHugh (R NY) and Danny K. Davis (D IL) demonstrate, the House Committee on Government Reform Report accompanying H.R. 22, 109-66 Part I is critical to understand the intent and provisions of H.R. 6007 (which had no report), which was ultimately enacted as the Postal Accountability and Enhancement Act. 152 *Cong. Rec.* E2244 (2006)(Statement of Hon. John M. McHugh)(Statement of Hon. Danny K. Davis).
[20] *H.R. Rep No*. 109-66 Part, I at 43, 44, (2005), available at http://www.gpo.gov/fdsys/pkg/CRPT-109hrpt66/html/CRPT-109hrpt66-pt1.htm

Any suggestion that Congress' intent to enable the Postal Service to better compete and respond to market forces was somehow limited to parcels and other competitive products is plainly incorrect in light of the legislative history of the Postal Accountability and Enhancement Act, cited above, which is right on point. Rather, Congress' intent to encourage the Postal Service to better compete in the *digital communications marketplace*, which is *exactly* what it is doing with this NSA, could not have been more clear.

III
The Commission's Accepted Methodology Should Not Apply Here

The Commission's "accepted methodology" for determining the value of an NSA and the way it is applied is now ten years old and predates the enactment of the PAEA. Putting aside the issue of the continued usefulness of the test,[21] we submit that it simply does not apply *here*. That test, which does not take into account penalties, was created for a declining block discount structure, and this NSA does not encompass such a structure. Under the structure of this NSA, incentives work quite differently from those in a declining block discount, and they indeed work in several different ways in this NSA.

As shown in Section IV below, analyzing the ways incentives work in this NSA yields results that are much different from those calculated by the accepted methodology. At Discover, NSAs have earned the attention of the highest levels of its

[21] We must point out that since the test predates the passage of the PAEA, it was never designed to function in an environment where this country's postal policy supports doing everything possible to encourage the Postal Service to better compete in the digital communications marketplace, so that it can survive and prosper as the PAEA envisioned.

marketing department, where senior executives follow whether the company is on track to meet its thresholds. Late in the year, if the decisions of the individual marketing teams (see below) do not seem to be yielding threshold-breaking revenues, those senior Executives intervene to assure that the thresholds are met and Discover gets the rebate for which it budgeted. That specifically happened during Discover's previous NSA. The effect of this dynamic is quite different from that of the accepted methodology, and we have included a technical analysis of it in Section IV below.

Beyond that, the incentives at Discover also work at a more granular level. Discover's individual marketing decisions about the mail channel are not made "at the margin," where marginal discounts incent the mailing of additional pieces.[22] Rather, they are made at the inception of a campaign, when Discover's individual marketing teams make decision among channels[23] and the decision to use or not use channels is based upon a matrix of 22 interdependent Key Performance Indicators and metrics.[24] These decisional factors interrelate with each other, and combine to create a unique set of decisional elements that are generally different in every case. In each of these cases, price interacts with the other variables to yield a unique solution that makes precisely isolating the effect of price unrealistic.[25]

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[22] Talwar at 14, 16-18.
[23] As CMO Talwar detailed in 15 pages, there are *nine* different targeted marketing channels, one of which is mail. That means that there are *eight* channels competing against the mail channel and with each other. Not only is this a robust competitive marketplace, but it could also be a more robust competitive marketplace than the parcel marketplace. Talwar at 7-16.
[24] Talwar at 17.
[25] Common sense alone suggests that any analysis that eliminates 21 of 22 decision metrics is not going to be a reliable source of prediction.

IV.
An Improved Panzar Test Shows that the NSA Improves Postal Service Finances and Finds Plausible Elasticizes

As discussed above, Discover's decision-making process cannot be boiled down to a simple mathematical equation. Consequently, the value of this agreement to the Postal Service cannot be precisely quantified. Notwithstanding this, should the Commission persist in seeking precise quantification, we have reviewed the Commission's accepted methodology for estimating the value of a NSA to the Postal Service pursuant to that methodology and believe that, technically, the method does not accurately measure the value of this particular NSA to the Postal Service.[26]

Our main technical problem with the application of the accepted methodology to this NSA is that the marginal discounts (2.5 percent of postage) used in this method do not accurately capture the substantial incentives the NSA provides to achieve the volume and revenue growth thresholds to qualify for the 2.5 percent rebate.[27]

Specifically, as detailed in DFS-LR-1[28], Discover has a $12.6 million incentive (the combination of avoiding a $4.5 million penalty and qualifying for an $8.1 million rebate) for Discover to increase its Year 1 volume from the Before-Rates to After-Rates volume. This translates not into a 2.5 percent marginal discount, but rather a 22.3 percent incentive on incremental pieces to grow volume. Based upon this more accurate calculation of the incentive to grow volume, the implied absolute values of

[26] DFS NSA Financials (Attachment F).xls, Tab "5_Commission's Methodology."
[27] It is not surprising that the accepted methodology understates the volume growth incentive of this NSA because the accepted methodology was based upon an agreement that provided a rebate only on volumes above a threshold. This agreement, on the other hand, provides rebates on <u>all</u> volume if thresholds are met and also includes a penalty for not meeting certain thresholds.
[28] LR-1.xlsx, Tab "FCM Growth," row [h].

elasticity of Discover's mail, while still higher than those used in the Commission's accepted methodology, is less than one.

Also and perhaps more importantly for the purpose of assessing whether the NSA improves the Postal Service's financial position, DFS-LR-1 analyzes the volume growth incentive provided by the NSA, implied elasticity, and net value to the Postal Service under a variety of Before-Rates volume scenarios.[29] As summarized in Table 1 below, the NSA improves the Postal Service's financial position even if Before-Rates volumes exceed (1) the Postal Service's forecast of 1.03 billion pieces[30] by more than 150 million pieces, and (2) Discover's FY 2014 volumes of 1.125 billion pieces[31] by 60 million pieces.

Further, all implied elasticites for these scenarios have absolute values of less than one with many being smaller than those in the Commission's accepted methodology.

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[29] It performs this analysis under two scenarios regarding the After-Rates mail mix between First-Class Mail and Standard Mail: (1) USPS After-Rates mail mix; and (2) assuming that all incremental volume is Standard Mail.
[30] DFS NSA Financials (Attachment F).xlsx, Tab "1_Inputs," cell F176.
[31] CHIR No. 1_QU 1.xlsx, Tab "QU 1," Call D28.

Table 1. Key NSA Statistics

Before Rates Volume	First-Class and Standard Mail Growth			All Growth Is Standard Mail		
	Growth Incentive	Implied Elasticity	USPS Value (Millions)	Growth Incentive	Implied Elasticity	USPS Value (Millions)
1,029,793,777 [1]	$ 12,644,781	0.987	$ 23,536,897	$ 12,510,362	0.903	$ 18,835,848
1,040,000,000	$ 12,379,277	0.909	$ 22,023,401	$ 12,253,326	0.833	$ 17,618,520
1,050,000,000	$ 12,119,137	0.835	$ 20,540,487	$ 12,001,484	0.766	$ 16,425,790
1,060,000,000	$ 11,858,998	0.763	$ 19,057,573	$ 11,749,642	0.702	$ 15,233,059
1,070,000,000	$ 11,598,858	0.695	$ 17,574,658	$ 11,497,800	0.640	$ 14,040,328
1,080,000,000	$ 11,338,719	0.629	$ 16,091,744	$ 11,245,958	0.580	$ 12,847,597
1,090,000,000	$ 11,078,580	0.566	$ 14,608,830	$ 10,994,116	0.523	$ 11,654,867
1,100,000,000	$ 10,818,440	0.505	$ 13,125,915	$ 10,742,274	0.469	$ 10,462,136
1,110,000,000	$ 10,558,301	0.448	$ 11,643,001	$ 10,490,432	0.417	$ 9,269,405
1,120,000,000	$ 10,298,161	0.393	$ 10,160,087	$ 10,238,590	0.367	$ 8,076,674
1,130,000,000	$ 10,038,022	0.342	$ 8,677,172	$ 9,986,748	0.320	$ 6,883,944
1,140,000,000	$ 9,777,883	0.293	$ 7,194,258	$ 9,734,906	0.276	$ 5,691,213
1,150,000,000	$ 9,517,743	0.247	$ 5,711,343	$ 9,483,063	0.235	$ 4,498,482
1,160,000,000	$ 9,257,604	0.205	$ 4,228,429	$ 9,231,221	0.196	$ 3,305,751
1,170,000,000	$ 8,997,464	0.166	$ 2,745,515	$ 8,979,379	0.161	$ 2,113,021
1,180,000,000	$ 8,737,325	0.131	$ 1,262,600	$ 8,727,537	0.128	$ 920,290
1,185,000,000	$ 8,607,255	0.114	$ 521,143	$ 8,601,616	0.113	$ 323,925
1,190,000,000	$ 8,477,186	0.099	$ (220,314)	$ 8,475,695	0.099	$ (272,441)
1,200,000,000	$ 8,244,273	0.072	$ (1,458,365)	$ 8,223,853	0.073	$ (1,465,171)

[1] USPS Year 1 Before Rates Volume Forecast

CONCLUSION

For the reasons set forth above, the Commission should approve this NSA. Moreover, even if the Commission should find a technical flaw with the Postal Service's approach, we respectfully submit that the Commission critique the technical flaws but nevertheless approve the NSA enthusiastically and commend the Postal Service for its attempts to tackle the challenges of the digital age, challenges that it is going to continue to face in the foreseeable future.

If the Commission should insist upon using a quantitative test, the process described in Section IV above is superior to that of the Commission's accepted methodology, at least in this instance.

Respectfully submitted,

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